BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of [REDACTED], Petitioner.	))))))	DOCKET NO. 18871 DECISION

On March 25, 2005, the staff of the Income Tax Audit Bureau of the Idaho State Tax Commission issued a Notice of Deficiency Determination to [Redacted] (taxpayer) reducing the claimed refund of tax for the taxable years 1997 through 2000 by the total amount of $4,975.

On May 27, 2005, the taxpayer filed a timely appeal and petition for redetermination. The taxpayer did not request a hearing but rather kept insisting that the Internal Revenue Service (IRS) accepted his returns and that he was told the state would follow the IRS. The taxpayer stated he provided all the federal information to the auditor to verify the IRS's acceptance of his federal amended returns. The Tax Commission, having reviewed the file, hereby issues its decision.

In 1998, the taxpayer and two other individuals entered into a business relationship [Redacted]. The taxpayer's contribution to the LLC was his expertise and management [Redacted]. The taxpayer was a 50 percent sharing member in the LLC's profits and losses. The LLC [Redacted] reported all its activities as 100 percent Idaho. The LLC elected to be treated as a partnership for tax purposes.

For 1998, 1999, and 2000, the taxpayer filed Idaho individual income tax returns reporting the pass-through income or loss from the LLC. The taxpayer timely filed his 1998 and 1999 Idaho income tax returns, but his 2000 return was filed nearly a year and a half past the due date of the return.

In December 2000, the taxpayer decided to leave the LLC. He stopped by the other members' home, dropped off his keys to the business, and walked away, effectively abandoning the LLC. The taxpayer stated that a resignation letter was also provided to the other members of the LLC. As a result of the taxpayer abandoning the LLC, he walked away from his capital account in the business that had an account balance of $78,831. On the taxpayer's original 2000 Idaho income tax return, the taxpayer reported an ordinary loss from the business activities of the LLC of $18,888. The taxpayer included a statement with his 2000 return that he was electing to forego the carryback of his 2000 net operating loss.

On the same date that the taxpayer filed his 2000 Idaho income tax return, the taxpayer filed amended returns for the tax years 1998 and 1999. The taxpayer claimed the K-1s he received for 1998 and 1999, reporting his share of the LLC's profits and losses, were fraudulent. This triggered an examination by the Idaho State Tax Commission and the IRS. The IRS resolved the issue when it disallowed the 1999 amended return for the apparent reason that the taxpayer agreed that the K-1s were correct. As to whether a loss was sustained in 2000 on the abandonment of the LLC, the IRS stated that the abandonment would have to be addressed in an examination of the 2000 federal tax return not the 1999 federal tax return.

Subsequently, on March 15, 2004, the taxpayer filed a second set of amended Idaho income tax returns for the tax years 1997 through 2000. The amended returns were to "include a net loss on a transaction that was omitted." The taxpayer included a statement with the amended returns saying that the IRS had reviewed and accepted the same federal amended returns. The Bureau requested information from the taxpayer that showed the IRS examined the amended returns and agreed to the characterization of the loss. The taxpayer provided copies of letters from the IRS stating that it changed his 1998 and 1999 returns because the taxpayer requested a tentative carryback or a restricted interest claim. The taxpayer also provided copies of the refund checks he received from the IRS.

The Bureau reviewed the information and determined the IRS letters and information did not address an examination of the character of the loss claimed on the abandonment of the LLC. Therefore, the Bureau reviewed the information available regarding the loss and determined the loss should be characterized as a capital loss. As such, the taxpayer is only allowed to carry the loss forward and is limited to offsetting gains or $3,000 per year.

In addition to the abandonment loss, the taxpayer reported a loss from the business activities of the LLC for the time that he was a member of the LLC in 2000. The taxpayer originally elected to forego the carryback provisions of Idaho Code section 63-3022(c) for the net operating loss in 2000. However, the taxpayer did not timely file his 2000 Idaho income tax return, and the election to forego the carryback of a net operating loss can only be made on a timely filed return. Therefore, the Bureau corrected the taxpayer’s amended returns to reflect the carryback of the taxpayer’s 2000 net operating loss.

The Bureau disallowed the amended return for 1997 in its entirety. The taxpayer claimed a refund for the carryback of the abandonment loss and for income that was incorrectly reported on the taxpayer’s original 1997 Idaho income tax return. The Bureau disallowed the claim because a net operating loss from the 2000 tax year can only be carried back to the two immediately proceeding years and the statute of limitations for amending the 1997 return had expired.

When the taxpayer abandoned his interest in the LLC, he triggered the recapture provisions of Idaho Code section 63-3029B. In 1999, the LLC placed in service assets on which the investment tax credit was claimed. This credit flowed through to the taxpayer, and he claimed the credit on his original 1999 Idaho income tax return. However, when the taxpayer abandoned his interest in the LLC, the taxpayer no longer had an interest in the qualifying assets making his interest in the qualifying assets subject to recapture. The Bureau adjusted the taxpayer's 1998 return to recapture 80 percent of the flow-through credit from the LLC.

The Bureau sent the taxpayer a Notice of Deficiency Determination reducing the claimed refunds on the amended returns. The taxpayer disagreed with the Bureau's determination protesting the loss carryback from the abandonment of the LLC. The taxpayer stated that his loss was properly characterized as an ordinary loss eligible for carrying back as a net operating loss. The taxpayer stated the abandonment loss met the exception to the general rule for capital assets because the transaction was not a sale or exchange and he did not receive an actual or deemed distribution from the LLC. The taxpayer asked for a redetermination.

The Bureau referred the matter for administrative review. The Tax Commission sent the taxpayer a letter giving him two alternative methods for having the Notice of Deficiency Determination redetermined. The taxpayer contacted the Tax Commission asking that the Tax Commission refund his money. The Tax Commission discussed the matter with the taxpayer and asked him to provide some specific information that showed the IRS examined his 2000 federal return and allowed the treatment of the abandonment loss as an ordinary loss. The taxpayer stated he provided all that information to the auditor. The Tax Commission told the taxpayer that the information available did not show that the IRS examined his 2000 federal return. The only information provided were letters from the IRS stating that a change was made to his 1998 and 1999 returns at his request; that is through his amended returns. The taxpayer stated he would provide the information again. The Tax Commission also requested information from the IRS.

After several months the taxpayer provided his information. The Tax Commission reviewed the information and found it was the same information that was included in the audit file. The Tax Commission contacted the taxpayer and told him the information he sent did not establish that the IRS did an examination of the abandonment loss. The taxpayer stated that getting his refund from the IRS was a very long process. The taxpayer stated the majority of the contacts with the IRS were by telephone, and that he had to file the amended returns twice. The second time the returns were filed as suggested by a taxpayer advocate. Nevertheless, the end result was that the IRS refunded the tax paid in 1998 and 1999.

Still not convinced the IRS examined the taxpayer's characterization of the abandonment loss, the Tax Commission decided to wait on the response from the IRS before issuing its decision. Several months later, the Tax Commission received the information from the IRS. The IRS information was not conclusive. The information clearly showed the taxpayer filed an amended return for 1999 and that the IRS examined that amended return. The result of the examination was that the IRS denied the refund request because the taxpayer agreed that the K-1s filed by the LLC were correct. The basis of the amended return was that fraudulent K-1s were filed by the LLC. The IRS made no determination on the abandonment loss. The information also showed that the taxpayer filed subsequent amended returns and that refunds were issued. However, it does not show that any of the subsequent amended returns were examined by the IRS. [Redacted].

Therefore, after receiving all the information that is available from the taxpayer [Redacted], the Tax Commission hereby renders its decision upholding the Bureau's determination on the characterization of the abandonment loss and the carryback of the net operating loss from the business activities of the LLC. The Tax Commission also upholds the recapture of the investment tax credit; however, the credit recapture should be reported on the taxpayer's 2000 Idaho income tax return rather than his 1998 Idaho income tax return.

Law and Analysis

Net Operating Loss Carryback from Business Activities – Idaho Code section 63-3022(c) states that a net operating loss for taxable years beginning on and after January 1, 2000, shall be carried back to the two immediately preceding taxable years. Therefore, a net operating loss sustained in 2000 can only be carried back to tax years 1998 and 1999. This section does provide for a binding election to forego the carryback period, but this election must be made by the due date of the loss year return, including extensions. The taxpayer initially elected to forego the carryback period on his original filing. However, the taxpayer did not file his 2000 Idaho income tax return until October 4, 2002, almost one and a half years after the due date of the return. Therefore, the taxpayer's election was not timely and the 2000 net operating loss must be carried back to the two immediately proceeding years.

When the taxpayer amended his 2000 return in March 2004, he increased the net operating loss and carried the loss back to the three immediately preceeding years. However, as stated above, Idaho Code section 63-3022(c) provides for a carryback period of only two years. Therefore, the carryback to 1997 is not allowed and any loss allowable from 2000 is first absorbed in taxable year 1998.

Unemployment Compensation Reported in 1997 – In addition to the net operating loss carryback, the taxpayer amended his 1997 Idaho income tax return for unemployment compensation that should not have been reported to Idaho. Idaho Code section 63-3072 provides the period of limitations for amending Idaho income tax returns for credit or refund. Subsection (c) states that a claim for credit or refund must be made within the later of three years from the due date of the return or three years from the date the return was filed. The due date for the taxpayer's 1997 return was April 15, 1998. The taxpayer's amended claim for refund was filed March 15, 2004, well past the three year statute for filing a refund claim.

Ordinary Loss Characterization of the Abandonment of LLC Interest – Under the check-the-box rules issued by the IRS, an LLC can choose to be treated as a corporation, a partnership, or a disregarded entity (sole-proprietorship). In this case, the LLC chose to be treated as a partnership. Since the LLC elected to be treated as a partnership, the LLC falls under the partnership laws of taxation, Subchapter K of the Internal Revenue Code (IRC). When a partner abandons a partnership, the partnership, assuming it can continue as a partnership, must go through a process called a constructive liquidation. Code of Federal Regulations section 1.752-2(b)(1) describes a constructive liquidation as a situation in which all the partnership's liabilities become payable in full; all the partnership's assets, including cash, have a value of zero; the partnership disposes of all its property for no consideration; the partnership allocates its items of income, gain, loss, or deduction among the partners; and the partnership liquidates. If when the partnership constructively liquidates there are liabilities due and owing, the liabilities are allocated to the partners according to the partnership agreement's profit and loss sharing percentages.

In 2000, the year the taxpayer abandoned the LLC, the LLC had liabilities at the beginning of the year in the total amount of $62,183. At the end of the year, the LLC's liabilities were $4,321. Since the LLC's reporting period is a calendar year and the taxpayer abandoned the LLC sometime in December 2000, it is very likely the LLC had liabilities when the taxpayer abandoned the LLC. If the LLC had liabilities at the time the taxpayer abandoned it, the taxpayer would be attributed a share of those liabilities in the constructive liquidation of the LLC.

The taxpayer stated that when he walked away, that was it. He did not receive anything from the LLC nor did he pay any of the liabilities. IRC section 752 provides for the treatment of liabilities in a partnership. Subsection (b) states that any decrease in a partner's share of the liabilities of a partnership shall be considered as a distribution of money to the partner by the partnership. If the taxpayer did not remain liable for his share of the LLC's debts upon the constructive liquidation, the release of liability is considered a deemed distribution to the taxpayer.

Revenue Ruling 93-80 states that a loss from the abandonment of a partnership interest will be ordinary if there is neither an actual nor a deemed distribution to the partner. However, even a de minimis actual or deemed distribution makes the entire loss a capital loss. See Citron v. Commissioner, 97 T.C. 200 (1991). Consequently, since there appears to have been liabilities on the books of the LLC when the taxpayer abandoned his interest, he is deemed to have received a distribution on the release of his share of the LLC's liabilities. Therefore, any loss sustained on the abandonment of the taxpayer's interest is a capital loss. Capital losses for individuals are allowed in the year of the loss and the succeeding taxable years until fully absorbed. IRC section 1212(b). Capital losses do not contribute to a net operating loss for carryback purposes.

Investment Tax Credit Recapture – Idaho Code section 63-3029B provides for a credit against Idaho tax on the purchase of qualified investment property. In 1999, the LLC purchased qualified investment property and reported an investment tax credit flow-through to the members of the LLC. The taxpayer claimed his share of the Idaho investment tax credit on his 1999 Idaho income tax return. However, when the taxpayer abandoned his interest in the LLC, he no longer had an interest in the qualified investment property purchased by the LLC. As a result, the taxpayer did not hold his interest in the qualifying property for its full useful life, and the taxpayer is subject to recapture of the credit claimed. Idaho Code section 63-3029B(6). The taxpayer held his interest in the qualifying property for more than one year but less than two years. Therefore, his recapture percentage is 80 percent of the original credit claimed. IDAPA 35.01.01.715.04 Income Tax Administrative Rules (2000).

The Bureau recaptured the investment tax credit in the tax year 1998. The qualified investment property ceased to qualify for the taxpayer in 2000. IDAPA 35.01.01.715.02.c. (2000) states that the recapture of credit previously claimed against tax in prior taxable years is an addition to tax in the taxable year in which the property is disposed of or ceases to qualify. Therefore, rather than the recaptured credit being added to the tax in 1998, the recapture should have been added to the tax in 2000.

WHEREFORE, the Notice of Deficiency Determination dated March 25, 2005, is hereby MODIFIED, in accordance with the provisions of this decision and, as so modified, is APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the taxpayer's account reflect the following:

YEAR	REFUND CLAIMED	REFUND ALLOWED	TAX	INTEREST	TOTAL
1997	$(1,087)	$ 0	$ 0	$ 0	$ 0
1998	(2,804)	(1,543)	0	(227)	(1,770)
1999	(1,913)	0	0	0	0
2000	0	0	714	0	714
				TOTAL	$ (1,056)

The taxpayer received a refund in the amount of $1,056, and therefore no further refund need be issued.

An explanation of the taxpayer's right to appeal this decision is included with this decision.

DATED this ________ day of _________________________, 2007.

IDAHO STATE TAX COMMISSION

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COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ________ day of _________________________, 2007, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[REDACTED]
[REDACTED]

[REDACTED]
[REDACTED]

Receipt No.

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